

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

FOR

PASSIVE CURRENCY OVERLAY PROGRAM - INTERNALLY MANAGED

April 16, 2001

This Policy is effective immediately upon adoption. No previous Passive Currency Overlay Program Internally Managed Policy exists.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Passive Currency Overlay Program-- Internally Managed ("the Program"). The design of this Policy ensures that the currency exposure of the California Public Employees' Retirement System's ("the System") international equity program is managed with prudence and care. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of international equity.

II. STRATEGIC OBJECTIVES

The Program shall be managed to accomplish the following:

- A.** Reduce the System's International Equity Program's risk due to currency volatility.
- B.** Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A.** The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy. The Investment Committee delegates the responsibility for administering the Program through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).
- B.** The **System's Investment Staff** ("the Staff") duties include, but are not limited to, the following:

1. Developing and recommending the Policy to the Investment Committee.
2. Developing and maintaining a procedures manual, subject to periodic reviews and updates, outlining Staff operational procedures used in implementing this Policy.
3. Implementing and adhering to the Policy.
4. Recommending changes to the Program, it's guidelines or management practices, which are pertinent to ensure the continual achievement of the Program's objective.
5. Reporting to the Investment Committee, quarterly and more often as needed, about the performance of the Program. The Staff shall monitor the implementation of, and compliance with, the Policy. The Staff shall report concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing to the Investment Committee. Reports made by the Staff to the Investment Committee shall include explanations of the violations and appropriate recommendations for corrective action.
6. Communicating with other Staff, as needed, regarding investment strategy and investment results.
7. Monitoring, analyzing, and evaluating performance relative to the agreed upon benchmark.
8. Coordinating with the portfolio manager of the underlying equity portfolio and the System's master custodial bank to ensure that a clear understanding of the currency exposures of the underlying portfolio(s) exists with which the Program is overlaid.
9. Cooperating fully with other System Staff, the System's custodian, and General Pension Consultant on requests for information.

C. The **General Pension Consultant** (the "General Pension Consultant") is responsible for monitoring and evaluating the Program's performance relative to the benchmark and Policy. The General Pension Consultant shall report to the Investment Committee on a quarterly basis, in accordance with its contract.

IV. PERFORMANCE OBJECTIVE

The Program shall control risk rather than generate return. The Program shall reduce risk versus the volatility of the underlying equity portfolio. Results shall approximate that of the benchmark, within +/- 50 basis points in a 12-month period. The benchmark is the fully hedged currency return of the developed markets portion of the Passive International Equity Index Fund—Externally Managed.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Investment Approaches

1. The allocation to the Program shall represent a portion of the Total Currency Overlay Program. The percent of assets allocated to the Program shall be determined by considering the following:
 - a. Cost versus expected attained risk reduction versus other alternatives.
 - b. Optimal impact to the overall Currency Management Program.
 - c. The impact of cash flow management associated with settlement for the rolling hedge on the rest of the System's investment program and the underlying assets. Generally, longer duration forwards can reduce the volatility of cash settlement and should be considered if it were to be expected that a favorable impact to flow management would result.

The Staff shall conduct the appropriate analyses to support such a recommendation and provide these to the Investment Committee for its review and approval regarding allocation to the internal program. The strategic allocation to the Program, once approved by the Investment Committee, shall be specified and maintained in the Staff Operational Procedures Manual.

2. The target underlying international equity portfolio subject to the Program shall be the developed markets portion of the externally managed passive international equity index fund where the currency exposures of the equity portfolio are stable.

3. The viability of the Program shall be reviewed continuously.

B. Specific Parameters

1. The Program shall be passively-managed, meaning that the currency exposures represented in the designated portion of the underlying equity portfolio shall be as close to 100% hedged as operationally and cost effectively as possible.
2. The Program shall track a fully hedged benchmark that reflects the specific currencies of the underlying equity portfolio as specified in Section V. A. 2. of this Policy.
3. The Program shall execute currency transactions over the long currency positions of the underlying portfolio(s) of assets assigned to it. These currency positions may be executed in the forward currency markets or in related currency derivative instruments, subject to the policies specified in the Statement of Derivatives Investment Policy. The actual currency positions may include all currency exposures of the equity portfolio or a tracking basket, whichever is consistent with risk reduction and cost effectiveness.
4. The Program shall monitor its currency positions to avoid leverage. Currency positions taken shall constitute a designated hedge of the actual international assets identified in the underlying portfolio.
5. The System shall allow wider tracking error should there be deliberate decisions to redefine the developed markets portion of the externally-managed passive international equity index fund. This would include but not be restricted to the entry/exit of individual countries or the major rebalancing of country weightings within the Index.
6. The Program may include other portfolios or other currency functions as they relate to the System with prior Investment Committee approval.
7. Implementation of this Program shall comply at all times with the System's investment policies including, but not limited to, the following:
 - a. Statement of Derivatives Investment Policy.

- b. Internal Program-specific Investment Management Guidelines.

VI. BENCHMARK

The benchmark for the program shall be fully hedged and a function of the International Equity Program as it may be implemented.

VII. GENERAL

- A. This Policy contains a Glossary of Terms in Section IX. of this document.
- B. Investors, managers, consultants, or other participants selected by the System shall make all calculations and computations on a market value basis as recorded by the System.

VIII. DERIVATIVES AND LEVERAGE POLICY

A. Forwards, Options, and Swaps

- 1. Leverage shall be avoided as cited in Section V. B. 4.
- 2. The Portfolio may buy or sell non-exchanged traded derivatives, which includes over-the-counter forwards, options, and swaps.
- 3. Bona fide hedging of foreign currency exposure is the only acceptable strategy.

B. Restrictions and Prohibitions

Any action or transaction not expressly permitted by this Policy is prohibited unless presented to and approved by the Investment Committee.

C. Counterparty Exposure for Forwards, Options, and Swaps

- 1. The counterparty exposure shall be integrated and managed with existing System counterparty exposures.
- 2. Transactions shall be executed with counterparties rated A-

(Standard & Poor's) and A3 (Moody's) or higher.

IX. GLOSSARY OF TERMS

The following Glossary of Terms contains definitions also referenced in the System's Master Glossary of Terms.

Currency – The monetary unit of a sovereign state.

Custodian – A bank or other financial institution that provides custody of stock certificates and other assets of an institutional investor.

Derivative – An instrument whose value, usefulness, and marketability is dependent upon or is derived from an underlying asset. Classes of derivatives include futures contracts, options, currency forward contracts, swaps, and options on futures.

Derivatives Policy – CalPERS' Statement of Derivatives Investment Policy, as most recently amended.

Developed Market – A country that is considered by most investors to have a well-developed operating and regulatory structure for its capital markets. Generally, countries included in the custom CalPERS - FTSE Developed Index ex US, are considered to be developed markets.

Forward Contract – A non-standardized contract for a deliverable commodity or instrument that conveys the obligation to make or take delivery of that commodity or instrument at a future point in time, at a specified price.

Futures Contract – A standardized contract for a deliverable commodity or instrument which conveys the obligation to make, or take delivery of, the commodity or instrument at a future point in time, at a specified price.

Hedge, Hedging – Taking an investment position to counterbalance the risk of another position. Hedging is the offsetting of risk; diversification is the spreading of risk.

Option – An instrument, which conveys the right, but not the obligation, to buy or sell a deliverable instrument at a specified price.

Over the Counter (OTC) – The market for securities and traded products that are not listed on the major exchanges. OTC options are options with negotiated premium, strike price, and expiration date.

Policy – CalPERS' Investment Policy, Guidelines and Procedures for Currency Overlay – Internally Managed.

Swap – A contract where the parties agree to exchange the cash flows of the underlying assets in amounts specified by the contract.